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Ambulatory Surgery Center ("ASC") Transactions – An Overview and Primer of Key Issues

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The number of ambulatory surgical center ("ASC") purchase and sale transactions remained high in 2008. The most common structures for the typical transactions were as follows: (1) the acquisition of a majority interest in an ASC by a for-profit, strategic acquirer that focuses as a core business in buying majority interests, (2) the acquisition of a minority interest in an ASC by a for-profit, strategic acquirer that focuses as a core business in buying minority interests and/or investing in turnaround centers, and (3) the hospital acquisition of a minority or majority interest in a local ASC. In a fourth, less common structure, a hospital purchases an ownership interest in an ASC side by side with a third party ASC management company.

As the outlook for 2009 becomes clearer, the volume of transactions in which national companies buy majority interests in surgery centers is expected to decrease as compared to 2008. This is in part because as the latter half of 2008 emerged, and debt financing markets became very tight, multiples paid for such transactions decreased, and several of the traditional buyers in such transactions reduced the amount of buying they were doing. At the same time, the acquisitions by minority interest buyers and the investment by hospitals in existing ASCs tended to increase.

This article discusses several of the principal business and legal issues related to ASC acquisition transactions. It further discusses the traditional transaction documents and the key provisions that are often negotiated as well as key miscellaneous issues that parties should consider. This article does not focus on either de novo/start up ASCs nor on physician to physician sale transactions. Neither does this article focus on regulatory issues such as the Stark Act or Anti Kickback issues.

I. Pricing of Transactions.

The pricing for majority interest deals is often dependent upon the strength and the risks of the ASC being acquired. For example, a center with all of the following characteristics will typically receive the highest price on an EBITDA (earnings before interest, taxes, depreciation and amortization) basis: (1) location within a certificate of need state, (2) low reliance on out-of-network payments, (3) reasonable, but not overly high, reimbursement rates per procedure, (4) not overly dependent upon a few doctors, and (5) low levels of physician non-competition risk. A typical price for such an ASC may be 6 to 8 times EBITDA minus debt. A year ago, such ASCs might have sold for closer to 7½ to 8½ times EBITDA minus debt. Today, such ASCs often sell closer to 6 to 7 times EBITDA minus debt. Further, the pool of majority buyers is smaller than it was a year ago. With fewer buyers, the demand and the prices paid for profitable ASCs has decreased.

In a typical transaction, a majority buyer will buy 51% to 66% of the equity of a center, will also obtain a management agreement paying between 5% to 6% of collections, and the acquisition will be structured such that, at closing, there will be a certain amount of accounts receivable and cash minus accounts payable in the company. In essence, the sellers of the ASC cannot generally take out all of the accounts receivable and cash immediately prior to closing.

An ASC that has a less than perfect score on the five criteria set forth above – (1) Certificate of Need, (2) Out of Network, (3) Reimbursement Risks, (4) Non- Competition Issues and (5) Over-Reliance on Key Doctors, will receive a lower multiple of EBITDA per share. For example, the price may be a multiple of four to five times EBITDA minus debt as opposed to 6 to 7. Further, the number of possible buyers may be smaller, driving competitive bidding down even further.

Finally, an ASC with two or more of the key risk challenges will have much more difficulty finding a majority-interest buyer and will typically be sold at a lower price. Such ASCs can be more probable targets for turn-around buyers and minority-interest buyers.

Over the last few years, an increasing number of hospitals have become very competitive in such acquisitions and are paying prices close to what the national companies will pay. A hospital, in part, because it receives other referrals from the physician owners of the ASC, and often due to concerns as a tax exempt buyer, will usually have to obtain a third party valuation as to price and to defend such a transaction. Hospital competition in buying such shares has grown in part due to: (i) a reduction in national company pricing and (ii) an increase in the number of hospitals interested in buying into such ASCs.

There is also a new and growing group of buyers that are interested in buying at-risk centers at a reduced price with the intent to turn around such ASCs. Such companies may often choose to be buyers of a minority interest in such transactions versus a majority interest. For example, if you have an unprofitable center, one of the benefits of

partnering with a management company that specializes in turnaround projects is that while the existing owners sell a minority share to the turnaround company, there is still potential to participate in a second profitable sale to a majority interest buyer if and when the center becomes profitable.

II. Key Transaction Issues.

There are several interesting miscellaneous issues involved in the potential sale of an ASC. These include some of the following issues:

A. **Resale of Shares After Transaction.** Typically, a majority interest buyer will buy in at 6 to 8 times EBITDA. However, minority interest buyers of shares, such as physicians, will typically not purchase shares for more than 3 to 5 times EBITDA. This provides some concern from a regulatory perspective. In essence, at minimum, it is critical that when selling shares to physicians at a price that is different than the price of shares sold to a majority interest buyer, that a valuation be obtained (or at minimum rigorous analysis) to help support and clarify the rationale for the difference in price. The difference may be due to several factors, such as: (i) discount for a minority interest or lack of control, (ii) the fact that minority interest buyers of shares do not receive a lucrative management agreement, or (iii) for other factors that an appraiser may take into account when determining the fair market value of the shares. Parties should keep in mind that while expressing a valuation as a multiple of EBITDA may be a convenient and efficient method of estimating a purchase price, there are many factors that are accounted for in third party fair market value appraisal. In any event, it is critical that a valuation be obtained to help defend any such efforts and pricing.

B. **Limits on Indemnification.** A typical transaction will include limits on indemnification such that a physician owner, even if representations and warranties are ultimately breached, will not have liability for indemnification for more than the purchase price received by such seller. However, there may be "excluded liabilities" which are not subject to the limitation. Because the buyer after a transaction is reliant upon the physician owners, it is not often that we see claims for significant lawsuits in indemnification. That stated, there is an increased risk of lawsuits particularly where a center's results and business significantly erode after a purchase.

C. **Interest in Other ASCs.** The more interests that existing physicians in a project have in other ASCs, the more likely it is that the buyer will either decide not to pursue the transaction or significantly reduce the price of the transaction.

D. **Capital Gains Versus Ordinary Income.** Because the taxes that are paid on a capital gain in an ASC transaction equate to between 15% to 25% (this assumes a certain portion of the purchase price will be with taxed as ordinary income) as opposed to the 35% to 40% that parties pay on the ordinary income distributions each year, this provides an additional incentive to sell part of the ASC. In essence, if a party sold an ASC from which they typically receive profit distributions, for a multiple of 7 times EBITDA, it would take 10 to 11 years with distributions to receive the same amount as they receive on the sale transaction, taken on an after-tax basis. This is because the ordinary income distributions each year are taxed at 35% to 40% whereas the one time capital gain is taxed at a rate of 15% plus certain additional amounts.

E. **Financing Market.** The freezing of the financing market in 2008 has had a significant impact on the number of buyers for ASC transactions and the pricing for such transactions. Although there are still a significant number of buyers, as of the beginning of 2009, it is more often that we see a smaller number of buyers and pricing at 6 or so times EBIDTA for premier ASCs, as opposed to the 7 to 8 times EBITDA that we were seeing last year. The capital markets freeze has had several other important impacts on leveraged transactions. In a typical leveraged transaction, the buyer funds a portion of the purchase price with cash and then borrows the remainder of the purchase price from a bank or other lender. First, any transaction that requires debt has experienced significant delays over the past six months. Second, lenders of all kinds have generally tightened their credit standards; only the most credit worthy borrowers have been able to secure financing. Finally, once a loan commitment is received, banks have generally been much more strict about their documentation and their loan terms and conditions. For example, in the last two quarters of 2008, we have seen greater guaranty requirements and more stringent financial covenants.

F. **Provider Numbers and Licenses.** As part of a transaction, it is critical in the early stages to review what contingencies there are to obtaining a new Medicare provider number and a new state license. Many states interpret their licensure and change of ownership regulations very differently, although the text of the

statutes or regulations maybe very similar. In fact, we have even seen different CMS field offices and fiscal intermediaries interpret the same Medicare regulations differently in the same or similar circumstances. Some of the key questions that need to be considered are as follows:

1. Is a certificate of need required?
2. Will there be a slow down or delay in getting the new license or a new provider number?
3. Are there any conditions to improve the ASC or bring it up to date with current life safety codes before obtaining a new provider number?
4. Is a new provider number required or can the center continue using its existing number?
5. For Medicare, will a new Form 855 be required or can a change of information on Form 855-B be filed?
6. Are there currently pending any lawsuits or legislation that would materially harm the ability of the ASC to do business?

G. Billing and Coding Audit. Many surgery center companies require a billing and coding audit prior to the closing of a transaction. This is to help assure that the center does not have a great deal of exposure for past claims, and to also to assure that the revenues have been recorded correctly. Improper billing and claims can lead to significant liability as well as significantly change the potential after transaction net income of a center. For example, if revenues are overstated due to over billing, this would likely reduce net income on a prospective basis as well.

H. Fraud and Abuse Statute Compliance. Buying companies will be very concerned with whether or not a surgery center has maintained or substantially maintained safe harbor compliance during its operations and whether the center post transaction will operate in a manner consistent with the safe harbors. A center that is significantly out of safe harbor compliance may find it very hard to find a buyer for a transaction or may need to make changes to come into compliance as a condition to closing the transaction

III. Transaction Documents, Legal Documents and Process.

This section first focuses on the letter of intent that is entered into at the start of a transaction. Then, it discusses the three main transaction documents negotiated in such a purchase transaction. These include the purchase agreement, the operating agreement, and the management agreement. This section also provides a discussion of the key negotiated provisions.

A. Letter of Intent. The letter of intent or term sheet includes the negotiation of core transaction terms of the deal. Here, a party often starts with informal discussions with multiple potential buyers. Typically, a party that is looking to sell an ASC may start with a list of 10 to 12 possible buyers. After seeking out offers and signing confidentiality agreements, the Seller may receive offers from 4 to 5 potential buyers. Of those offers, two to three are often superior to the rest. The selling party will typically attempt to negotiate a letter of intent with each of these potential buyers with the intent of actually signing a letter of intent with only one party. Once a letter of intent is signed, a period of exclusive negotiations commences, with the intent to close the transaction with that one party.

Certain of the core terms negotiated as part of the letter of intent include: (i) the purchase price for the transaction, (ii) the ownership structure (i.e., what percentage will be sold), and (iii) whether it will be an asset or stock type transaction.

The letter of intent will also discuss such items as the accounts receivable minus accounts payable and cash amount required at closing, the terms of the management agreement including the compensation under the management agreement, the non-compete terms and the expected closing date.

The letter of intent will also set forth a lock-up period of time -- typically 60 to 90 days -- and note that the transaction is subject to several closing conditions such as completion of the core documents (i.e., the purchase agreement, operating agreement and management agreement), regulatory and licensure review and filing, and due diligence review. For buyers, the lock-up or exclusivity period is a key provision to ensure that the seller is only negotiating with that particular buyer. It may also include a break-up fee or liquidated damages clause.

The letter of intent will contain the non-binding obligations of the parties, as well as certain provisions which will be binding. For example, the purchase price to be paid and the relative post-closing governing rights of the parties may not be fully negotiated at the time a letter of intent is executed and may be subject to due diligence. Thus, the parties will make these terms non-binding and then negotiate in good faith to finalize those points in the core transaction agreements. Exceptions to the non-binding nature of a letter of intent often include the confidentiality provisions and the lock-up or exclusivity provision. Each of the parties typically cover their own expenses for due diligence during the negotiation period. This is also generally a binding agreement.

The parties, after a letter of intent is agreed to and executed, negotiate the purchase agreement, operating agreement and management agreement.

B. Purchase Agreement. The purchase agreement focuses on several key issues, including (1) the purchase price and the delivery of the purchase price (2) the discussion of any targets that are part of the purchase price such as working capital targets or cash balance targets, (3) a description of the assets purchased and liabilities assumed and the liabilities which are excluded, (4) the representations and warranties made by each party and what limits and qualifications are in place with regard to such representations and warranties, (5) the indemnification provisions, including the limits on and process for indemnification, (6) the non-competition provisions (these often have a much longer tail than in the operating agreement), (7) the closing date, (8) the process and any special terms of closing such as closing conditions (these may include physician syndication or other requirements), (9) termination provisions (e.g., under what terms can either party decide not to move forward), and (10) other promises and covenants that are to be made between the parties.

C. Operating Agreement. There are typically 8 to 10 key operating agreement issues. These include such items as:

1. <u>Seller Physician Reserve Rights</u>. In essence, what can the buyers in a majority interest transaction not do after the deal without physician approval? What issues will the physicians have veto or reserve rights over?

2. <u>Controlling Owner Dilution</u>. How do the physicians control the ability of the buyer to dilute them significantly? For example, do they approve of new owners, and will the buyer be diluted in part as well? Typically, the admission of a new member may require the approval of the members holding a majority of the units issued and outstanding in the company, in addition to the approval of the majority interest holder.

3. <u>Self Dealing Controls</u>. These are protections that the physician investors will have against the buyer entering into transactions with itself. These could, self dealing constraints, reduce the earnings of the company and the distributions to its physician members.

4. <u>Non-Competition Provisions</u>. These will typically describe what is restricted, as well as the time of the restriction and the radius of the restriction. A typical operating agreement will include a two to three year tail and a 10 to 30 mile radius depending on a number of factors. The covenants may also be drafted to be narrower or broader with respect to the conduct prohibited.

5. <u>Redemption Price of Units</u>. This will involve a description of the events that cause redemption of physician shares, whether the redemption events are mandatory or optional, and the price paid upon the occurrence of such events, and the timing of and limits on payments. Also partners often attempt to negotiate the ability to later buy out the buyer under certain circumstances..

6. <u>Amendments</u>. What control will each party have over amendments to the operating agreement. Will amendments require a super majority vote?

7. <u>Board</u>. The size of the Board, who elects the Board and what powers the Board has. Will the majority owner control the Board?

8. <u>Physician Ownership Requirements</u>. These are requirements for eligibility for physician ownerships. What requirements must a physician meet to continue to be eligible to be an owner and what requirements must a physician meet to initially become an owner of the LLC. Must a physician comply with the safe harbors for ASCs?

D. **Management Agreement**. The management agreement includes several key issues for negotiation. These include items such as (1) the length of the initial term and the renewal terms of the agreement (in a purchase deal, the term is often very long and cannot be terminated absent the buyer's approval), (2) the right of the physician owners to terminate the management agreement either without cause or with cause (and whether the agreement can be terminated without cause), (3) the manager's ability to halt services or resign, (4) the ability of a manager or buyer to charge for other expenses to the ASC and to provide other services, (5) the compensation to be received as a manager, whether percentage (often 4% to 6% of collections or accrued revenues) or flat management fee), (6) the method of calculating the management fee, (7) the potential for caps on or a decreasing percent in management fees (e.g., is there a decrease in the management fee after a threshold of collection is met), (8) indemnification for actions as manager and any limits on the indemnity, (9) the manager's expenses that are subject to reimbursement and (10) whether the manager will be subject to specific performance or bonus criteria.